COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

The Berkshire Gas Company	)))	D.T.E. 04-47

REPLY BRIEF OF
THE BERKSHIRE GAS COMPANY

I. STATEMENT OF PROCEEDINGS

In accordance with the procedural schedule established by the Hearing Officer, on September 24, 2004, The Berkshire Gas Company ("Berkshire" or the "Company") submitted its Initial Brief in support of its petition pursuant to G.L. c. 164, §76 and §94A seeking approval by the Department of Telecommunications and Energy (the "Department") of the Gas Portfolio Optimization Agreement between the Company and BP Energy Company ("BP Energy") dated as of March 22, 2004 (the "Portfolio Agreement") and the Gas Sales and Purchase Agreement between the Company and BP Energy dated as of March 22, 2004 (the "Purchase Agreement"; the Purchase Agreement and the Portfolio Agreement are referred to collectively as the "Agreements"). The Company's Initial Brief demonstrates that the Agreements are the product of a fair, open and transparent competitive solicitation process, that the Agreements are consistent with the Company's resource portfolio objectives and that the Agreements are consistent with the public interest.

The Attorney General of the Commonwealth of Massachusetts (the "Attorney General") also filed an Initial Brief on September 24, 2004. The Company's Reply Brief shall not restate the arguments from its Initial Brief, rather this reply brief shall address issues raised in the Attorney General's Initial Brief. The Company's failure to address any particular factual or legal argument raised in the Attorney General's Initial Brief should not be deemed to constitute a concession or waiver.[1]

II. THE ALLIANCE IS THE PRODUCT OF BERKSHIRE'S INNOVATIVE, COMPREHENSIVE AND EVOLVING PLANNING EFFORTS AND PROVIDES SUBSTANTIAL BENEFITS FOR CUSTOMERS WHILE THE ATTORNEY GENERAL'S ARGUMENTS RELATING TO THE ALLIANCE ARE MISLEADING AND ERRONEOUS

As noted in the Company's Initial Brief, the record in this proceeding and a substantial number of prior Department decisions demonstrate that Berkshire has long been an innovative leader in resource planning. See e.g. Berkshire Gas, D.T.E. 99-81 (asset management agreement); Berkshire Gas, D.T.E. 99-17/EFSB 99-2 (innovative and flexible LNG facility); Berkshire Gas, D.P.U. 94-168. Indeed, the 2001 Agreements were acknowledged by the Department to be consistent with the Company's planning objectives and the Department encouraged Berkshire's continuing effort to pursue innovative savings opportunities. Berkshire Gas, D.T.E. 01-41, p. 13 (BP Energy Alliance initial agreements), see also Berkshire Gas, D.T.E. 02-19 (The Department made similar findings regarding the 2002 Agreements).

The Company has demonstrated that the Agreements are substantially similar to the innovative agreements approved in D.T.E. 01-41 and D.T.E. 02-19 and that the Joint RFP confirmed that the alliance structure was the most attractive alternative available to the Company in terms of optimizing its resource portfolio. Co. In. Br., pp. 11-12. Accordingly, for all the reasons stated here and in the Company's Initial Brief, the Department should approve the Company's petition in this proceeding subject to such reasonable conditions as the Department has previously imposed with respect to the alliance.

The Attorney General has raised only limited, misleading, and generally unsupported assertions with respect to the Agreements, the alliance structure, the

[1] Capitalized terms not defined herein shall have the same meaning as in the Company's Initial Brief.

Company's proposal for margin sharing and the Company's treatment of certain costs associated with the 2002 Agreements. The Attorney General's arguments can largely be categorized as either (i) rehashing prior rejected arguments with respect to the alliance structure or miscasting the nature of the Agreements and the Company's actual efforts to apply its resource portfolio to generate margins for the benefit of customers; (ii) suggesting that the Company has somehow not effectively managed alliance agreements properly or that the Company has not been diligent in monitoring the alliance structure; (iii) erroneously describing the nature of the Company's margin sharing proposal while ignoring the evidence that, in all meaningful aspects, the Company has, in fact, satisfied the Attorney General's own articulated standard for margin sharing; and (iv) mischaracterizing the Company's appropriate treatment of a portion of the costs relative to the 2002 Agreements. Importantly, the Attorney General has not challenged the nature and quality of the Joint RFP process. Given the fact the Joint RFP process was essentially identical to those that resulted in the 2001 Agreements and the 2002 Agreements, the Department should find that the solicitation process was "open, fair and transparent" and that such process was "appropriately conducted." Berkshire Gas, D.T.E. 02-19, p. 11.

III. THE DEPARTMENT SHOULD DISREGARD THE ATTORNEY GENERAL'S CRITICISMS RELATING TO THE NATURE OF THE ALLIANCE AGREEMENTS

The Attorney General raises several arguments relating to the appropriateness or merits of the alliance structure and the terms and conditions of the Agreements. The Attorney General can only sustain these arguments if he ignores the record evidence and substantial Department precedent (including prior decisions relating to the alliance) or relies upon wholly unsubstantiated assertions.

First, the Attorney General rehashes his previously rejected argument that the Agreements are not in the public interest because BP Energy may "retain monetary benefits." AG In. Br., p. 6. The fact that an entity such as BP Energy would require some form of compensation for providing strategic and tactical advice that enables the Company to secure savings beyond what could be achieved by the Company on its own hardly renders the Agreements improper. Cf. Exh. BG-3, Art. IV; Exh. Ag-1-19, Att. I. The Department has previously recognized the benefits of working with an expert advisor. See Berkshire Gas, D.T.E. 99-81; Boston Gas, D.T.E. 99-76; Berkshire Gas, D.T.E. 01-41, p. 12; Berkshire Gas, D.T.E. 02-19, p. 16. In fact, in D.T.E. 02-19 (p. 16), the Department properly recognized that, "by its very terms," the alliance structure provides that the Company will "pay no more for natural gas . . . [than it] would have in the absence of [the 2002 Agreements]." The Department also went on to recognize that the Company shrewdly structured the 2002 Agreements so that BP Energy's expertise and the ability to "aggregate" transactions among the LDCs result in BP Energy maintaining a "strong incentive" to achieve "additional gas-related savings." Id. In fact, the Department found that Berkshire's customers "will likely benefit from the Alliance arrangement even under the most unfavorable optimization conditions." Id. at p. 17, n.13. This same essential structure is preserved in the Agreements. Berkshire will make no out-of-pocket payments, is eligible for a minimum guaranteed payment and secures the majority of benefits attainable under more likely scenarios relating to market conditions and optimization. Co. In. Br., p. 12.[2] Berkshire and its customers benefit by this alignment of incentives for all alliance participants. Berkshire's customers are better off within the alliance structure.[3]

[2] The Attorney General's only argument showing potential "losses" relates to the situation if the Department rejects this petition. AG In. Br., p. 6. In fact, the Company candidly noted that some costs would be incurred in "winding down" if the Agreements were not approved or if the Agreements are terminated by Berkshire when furthering its "good utility practice" objectives. Exh. AG-1-8.

[3] The Attorney General compares the alliance structure to an "asset management" agreement and ignores the obvious benefits of the alliance structure. AG In. Br., p. 12. The Attorney General properly recognizes that under such an agreement a utility's capacity resources are turned over to the manager and the utility receives no benefit other than the established payment. Under the alliance, Berkshire, however, is insulated from the risk of unfavorable transactions, maintains a meaningful guaranteed minimum payment and receives the vast majority of "up side" benefits. Thus, Berkshire's customers, not the asset manager, benefit most when market conditions are favorable for capacity release or off-system sales.

Second, the Attorney General makes a series of arguments that totally disregard the manner in which the alliance structure works for the benefit of customers. The Attorney General suggests that the use of derivative transactions within the alliance structure will somehow place customers at "risk of harm from BP's poor financial decisions." AG In. Br., pp. 7-8. The Attorney General later asserts, without any record support, that not only are savings shared within the alliance, "but losses are also shared." The Attorney General apparently is suggesting that somehow Berkshire's customers may be harmed through the alliance. In fact, as recognized in D.T.E. 02-19, Berkshire's customers cannot, by definition, pay more for gas than would otherwise be payable pursuant to contracts expressly approved by the Department or in the course of a forecast and supply plan review. Berkshire Gas, D.T.E. 02-19, p. 16; see also Co. In. Br., pp. 18-19.

The Company also explained that derivative instruments are necessary in order to "capture" savings. Thus, once the alliance identifies an opportunity, two transactions will be executed, generally simultaneously, one "physical" and a related derivative transaction. There is simply no speculation involved.[4] No transaction is executed until it has been discussed with and approved by the Company. Co. In. Br., pp. 15-17. Moreover, the fact that derivative transactions are entered into by BP Energy, in fact, confirms the Company's assertions as to risk mitigation. Simply put, any risk for these types of transactions is borne entirely by BP Energy while Berkshire and the other LDCs each maintain the right to control transactions pursued with their assets while only sharing in any "up side."[5]

[4] While reports of transactions for selected periods may reflect a "loss," this is merely a timing difference reflecting the differing settlement dates for various optimization transactions. See, e.g. Exh. AG-1-4; Exh. AG-1-31; see also Berkshire Gas, D.T.E. 02-19, p. 16.

[5] The alliance risk level is also lower than the Attorney General's preferred asset manager approach because Berkshire never assigns its contracts and therefore has no exposure to a bankruptcy of the manager.

The Attorney General next argues against the alliance "structure" because it purportedly "reduces the savings available to ratepayers consistently over time." AG In. Br., p. 8.[6] The Attorney General's arguments wholly miss the point. First, the Attorney General completely ignores the fact that the Agreements were only executed after a rigorous and transparent competitive process. Berkshire properly selected BP Energy's proposal as the most competitive. Co. In. Br., pp. 6-9. The Department should not be persuaded by the Attorney General's mischaracterizations. The argument that a more attractive opportunity may have been available on the market three years ago or two years ago is irrelevant.[7] Importantly, the Attorney General has not provided any basis for the Department not to again conclude: (i) that the alliance provides the same beneficial opportunities and same important contribution to an overall least cost resource plan that the Department has previously recognized; and (ii) that the alliance represents the most attractive alternative <u>now</u> available to the Company.[8]

Berkshire continues to believe that the appropriate goal in its margin generation efforts is to implement an overall least cost resource plan. The Company has demonstrated how the alliance contributed to such a plan. In a year where costs are low and stable and weather mild, it is probable that "optimization" results may be in the lower range. Happily, customers will benefit substantially from these low, stable prices given

[6] Notably, the Attorney General also mischaracterizes the level of the minimum guaranteed payment as "far less" than under the 2002 Agreements. In fact, the reduction from the 2002 Agreements is only ten percent. Exh. AG-1-2, §1.6. However, even this analysis is not complete. The expansion of the alliance to include RG&E is expected to enhance savings opportunities and thereby increase benefits for all parties. Thus, the 2004 Agreements may be reasonably expected to secure equal or higher savings under comparable market conditions.

[7] The Attorney General suggests that there is an inconsistency in the Company's statements as to whether BP Energy or another bidder had the best "back office" capabilities. AG In. Br., p. 6, n. 10. The Company's response to Information Request AG-1-26 noted that BP Energy had the best quality "systems". The actual scoring analysis indicated that BP Energy and another bidder's systems were "acceptable" (Exh. AG-1-19, Att. I, p. 12) or even "excellent" (Co. In. Br., p. 6; Tr. 168), some computer systems maintained by another bidder "were considered better." BP Energy, however, was experienced with the alliance structure and, therefore, "a smooth transition would be anticipated." BP Energy also has discussed plans to enhance its computer system capabilities.

[8] As noted, previously, unlike an asset management agreement, the alliance structure, in fact, permits the capture of greater savings and provides strong incentives for all parties to achieve that objective.

the approved supply contracts maintained by the Company.[9] Alternatively, when prices are high and volatile, optimization opportunities are more substantial and results would likely be in the higher range. The Agreements are appropriately structured so that savings opportunities for the Company are not capped for the simple reason that, in these conditions, optimization results will play a more important role in securing a least cost plan for the benefit of customers. The Company has always been clear about the "opportunity" benefits that result from the alliance and the contribution of the alliance to the Company's overall planning goals. Berkshire Gas, D.T.E. 01-41, p. 12; Berkshire Gas, D.T.E. 02-19, pp. 16-17.

Finally, the Attorney General's assertion that a revision to the Optimization Agreement has somehow added inappropriate risk to Berkshire is simply misplaced. AG In. Br., pp. 6-7. In fact, the revision to Section 2.4 of the Optimization Agreement addresses a single, narrow purpose. Section 2.4 was revised to facilitate compliance with the so-called "shipper must have title" rules of the Federal Energy Regulatory Commission. Exh. AG-1-27. Rather than exposing the Company to some added risk, this revision demonstrates the strong commitment to regulatory compliance within the alliance team and ensures that alliance transactions will be conducted in full compliance with relevant regulatory requirements.

In sum, the Agreements provide the greatest opportunity for benefit to Berkshire's customers, result in a structure whereby Berkshire has no "down-side" risk and has preserved the important right to an unlimited "up side" when optimization transactions such as capacity release are most beneficial. The Company has established a structure whereby derivative transactions are pursued by BP Energy not for speculative purposes but, rather, to capture savings opportunities. Further, the risk

[9]Again, the Agreements are structured with a guaranteed minimum payment, so even under the most unfavorable optimization conditions, the Company's customers are likely to benefit. Co. In. Br., p. 12; Berkshire Gas, D.T.E. 02-19, p. 17, n. 13.

of such transactions is shifted to BP Energy. The Department should again recognize that the alliance's contractual structure remains consistent with Berkshire's portfolio objectives and secures the maximum benefit for customers. In sum, the Agreements continue to provide the same important benefits previously recognized by the Department.

IV. THE COMPANY HAS MANAGED AND WILL CONTINUE TO MANAGE THE ALLIANCE STRUCTURE DILIGENTLY AND APPROPRIATELY

The Attorney General challenges the Company's management of the alliance structure based largely on two factors: (i) purported deficiencies in the Company's reporting efforts; and (ii) allegations of impropriety with respect to a recently-completed audit report. In fact, neither argument is at all compelling and can only be advanced with the most spurious assertions. The Company has fully satisfied the Department's requirements with respect to reporting and, moreover, has pursued additional diligence by completing a voluntary and comprehensive audit of performance under the 2002 Agreements. The record also demonstrates the Company's commitment to full compliance with regulatory requirements and willingness to undertake additional compliance or monitoring efforts when appropriate to ensure regulatory satisfaction with relevant transactions.

First, the Attorney General suggests that the Company somehow "turned a blind eye" to BP Energy's "mismanagement" of Company assets in its purported failure to "enforce filing deadlines for annual reports." AG In. Br., p. 4. The first error in this argument is that, of course, BP Energy does not "manage" Berkshire's gas assets. See Section III, supra. Second, in Berkshire Gas, D.T.E. 02-19, p. 19, the Department directed the Company to submit annual reports "detailing any refinements to the allocation methodology as suggested in the [2002 audit report], including the savings dollars accruing to the Company and how savings generated and allocated between the LDCs, and a summary of the BP transactions on behalf of the Company." The annual report, which was to be due 60 days from the end of every year, was also to describe "problems" arising during implementation and how Berkshire and BP Energy have addressed any such problems. Id. The best that the Attorney General can muster is that somehow the Company did not meet the Department's original deadline. The Attorney General cites no concerns with the contents of the reports because, in fact, the reports fully addressed the Department's requirements. While the Company required additional time to complete the mandated reports,[10] Ms. Zink fully explained the fact that the Company alerted the Department as to the need for additional time in the preparation of its reports. Tr. 85-86. In sum, the record demonstrates the seriousness of Berkshire's commitment to the reporting effort and how the Company properly alerted the Department as to its ongoing efforts to complete the required annual reports. The reports, when filed, confirmed the substantial benefits to customers secured by the optimization transactions pursued by the Company in the context of the alliance.

The Attorney General also challenges the Company's efforts to ensure compliance with its derivatives policy in terms of reporting. AG In. Br., p. 5.[11] The Company's derivative policy, in fact, applies only to Berkshire's execution of derivative transactions, limits such transactions to hedging purposes only and requires certain reports upon execution. In the alliance, BP Energy is the party that enters any derivative transactions and then only after consultation with the Company. Thus, besides further insulating the Company from risk, no transaction-specific report is required by the terms of the policy. In any event, all relevant Energy East officials are fully aware of the nature of the alliance, related derivative activity and the results of audits. The Attorney General

[10] The 60-day requirement was not briefed in Berkshire Gas, D.T.E. 02-19. If such question had been briefed, Berkshire would have explained the inability to report all reconciled transactional information within that timeframe.

[11] The Attorney General begins his argument with a baseless assertion that somehow Berkshire was inconsistent in its description of the Department's previous consideration of the Company's derivatives policy. See AG In. Br., p. 5, n. 7 citing Exh. AG-1-4. The Company's response in Exh. AG-1-4 is entirely accurate. The Department has necessarily considered the policy in prior alliance proceedings.

can make no meaningful argument that this level of oversight is in any way inadequate or inconsistent with the established derivative policy.

The Attorney General next criticizes the Company for somehow failing to produce a voluntary audit of performance under the 2002 Agreements in time for review in this proceeding. AG In. Br., pp. 5-6. The Attorney General then, without citation, makes the egregious suggestion that the Company intentionally withheld "many documents that are crucial" to reviewing this petition. Id. at 6. (The only citation provided by the Attorney General to support this assertion is to the September 16, 2004 Internal Audit Report provided in Exh. DTE-1-25 (Supp.) (the "2004 Audit Report")). These inaccurate and irresponsible arguments must be rejected. First, the 2004 Audit Report was voluntarily undertaken by the Company and in no way directed by the Department. Thus, rather than being a point for criticism, the Department should recognize the diligence by which the Company not only targeted savings opportunities but also managed and tracked savings and allocation calculations. A review of the actual reports on performance that the Department directed the Company to file (Exh. AG-1-4 and Exh. AG-1-31) demonstrates the degree of care applied by the Company.[12] In any event, the Attorney General's criticisms should be recognized as an attempt to stand logic on its head. Berkshire had no interest in delaying the 2004 Audit Report; indeed, the record reflects the Company's efforts to secure the issuance of such report. See, e.g. Tr. 177. Moreover, while helpful in confirming that appropriate procedures and controls were in place, such an audit is normally not even available when the Department evaluates the merits of a contract. Indeed, no audit was available to the Department or the Attorney General in Berkshire Gas, D.T.E. 01-41. Finally, Berkshire unequivocally challenges the Attorney General's baseless assertion that many documents were inappropriately

[12] Importantly, the Company was pleased to note in both annual reports that there were no material problems in terms of the implementation of the alliance. Exh. AG-1-4; Exh. AG-1-31.

withheld in this proceeding and submits that the Department should weigh this assertion against the Attorney General when considering his other arguments.

A review of the 2004 Audit Report actually confirms the diligent manner in which the alliance structure has been pursued. The 2004 Audit Report concluded that procedures and controls at BP Energy are "reasonable and are functioning as intended." Co. In. Br., p. 20. The 2004 Audit Report also concluded that savings calculations were made as intended and payments were made in accordance with the 2002 Agreements. Id. at 20-21. The 2004 Audit Report did offer some constructive suggestions regarding greater promptitude of confirmation activities and the enhancement of record retention practices. In fact, one of the primary purposes of such an audit is to identify areas for improvement or enhancement. Importantly, the Company has agreed to implement the suggested enhancements from the 2004 Audit Report. Exh. DTE-1-25 (Supp.). The audit served its purpose and has helped the Company to refine and enhance the alliance process.[13]

The Attorney General then goes on to suggest that the Department condition approval of the Agreements on particular and additional types of "independent" audits. These suggestions reflect his fundamental confusion on the appropriate limits and necessary timing of audit testing. The Attorney General's suggested "enhancements" include a requirement that the Company somehow engage an independent auditor to determine that "all" transactions executed within the alliance are made in the "best interest of customers." AG In. Br., p. 8. This proposal suggests a pre-transaction audit, which is obviously not feasible given the daily and intra-day need to execute optimization transactions. Co. In. Br., p. 11. Moreover, audits simply do not review all relevant

[13] The Company suspects that the Attorney General would have attacked the 2004 Audit Report as inadequate had it not included any suggestions for improvement.

transactions. As explained in D.T.E. 02-19, (p. 5), the goal of the audit process is not to review every single transaction (or even every transaction within a particular month). The purpose is to test and assess procedures and controls. Exh. DTE-1-25 (Supp.). The Attorney General's arguments would only lead to unnecessary and redundant testing or unacceptable delays in the execution of transactions. As was done in an audit performed in 2002, representative months were selected for a detailed audit review. Exh. DTE-1-25 (Supp.), p. 3 (Three months during the contract period were selected for detailed audit.); <u>cf</u>. <u>Berkshire Gas</u>, D.T.E. 02-19, p. 5 (One month selected for audit of 2001 Agreements). The Attorney General then suggests that a "final" audit of performance under the Agreements be submitted to the Department <u>prior</u> to any extension of the alliance structure beyond the term of the Agreements. AG In. Br., p. 9. The adoption of this proposal would likely achieve only the illogical result of precluding any extension of the alliance, an outcome that would hardly benefit customers. Simply put, a final audit could not be completed until well after the completion of the term of the Agreements and, therefore, the Company would likely be effectively precluded from negotiating an extension.[14] The Attorney General next suggests that any approval of the Agreements be conditioned upon the requirement of an independent audit. AG In. Br., p. 7. As demonstrated, such approach is unnecessary given the quality and comprehensiveness of the audit performed in this proceeding. Moreover, such an approach is likely to be less effective as external auditors are not likely to be as familiar with gas procurement and only a single layer of review will be secured, i.e., only the review of the external auditor. The Company's approach secures two layers of review – first the internal auditors and then the second level of review as all internal auditor reports are provided to the external auditors. Accordingly, the Department should reject

[14] Contrary to the Attorney General's assertion, the Company does not object to the timely submission of any report commissioned by an auditor with respect to the alliance. The Company submits, however, that any audit should be flexible enough to address the best interests of customers at the time of the audit. For example, if Berkshire does not expect to extend the alliance beyond the term of the Agreements, a different scope of audit could be appropriate for the third year of the term of the Agreements.

the Attorney General's criticism of the audit process, recognize the positive conclusions from the 2004 Audit Report in evaluating the Agreements and find that the Company has managed the alliance effectively and appropriately.

V. THE COMPANY HAS DEMONSTRATED THAT ESTABLISHED MARGIN SHARING PRINCIPLES SHOULD BE APPLIED TO MARGINS EARNED BY THE COMPANY IN CONNECTION WITH THE ALLIANCE

Berkshire has demonstrated that the Department's margin sharing principles should be applied to margins earned through transactions executed within the alliance. Co. In. Br., pp. 22-23. As the Department has properly recognized, under the Optimization Agreement, BP Energy essentially provides "consulting services." Berkshire Gas, D.T.E. 01-41, p. 11. Berkshire maintains "control of its dispatch decisions on a daily basis." Id. at 13; Berkshire Gas. Thus, as the Company described, it is pursuing a variety of transactions through the alliance, including capacity release ("CR") and off-system sales ("OSS"). Tr. 35. Indeed, references to "optimization" activities within the alliance are actually a reference for the structure pursuant to which the Company pursues transactions through one of the categories recognized in Interruptible Transportation, D.P.U. 93-141-A, here either CR or OSS. Id. Thus, the Department need only apply its well-established margin sharing principles when considering savings generated with the benefit of alliance assistance.[15]

The application of the principles established in D.P.U. 93-141-A to the alliance structure is entirely appropriate. Absent such margin sharing, Berkshire would have no incentive to have been as creative (or to have incurred the substantial costs) with respect to establishing the alliance that provides substantial benefits for customers. The Department noted that margin sharing structures provide LDCs "with an incentive to

[15] The Company also proposed, as an alternative, that rather than tracking alliance transactions to either CR or OSS, all such transactions might be considered in the aggregate. Co. In. Br., p. 23, n. 9.

consider seriously more aggressive capacity releases . . . ." Interruptible Transportation, D.P.U. 93-141-A, p. 61. The Company has, in fact, been extremely aggressive in seeking value for customers. Moreover, even if it is assumed that the types of transactions pursued through the alliance do not fit squarely within the established optimization categories, the application of these standards to this transaction is consistent with the more general principles articulated in D.P.U. 93-141-A.[16]

The Attorney General challenges the Company's straightforward proposal through a series of erroneous and misleading arguments. The Attorney General then articulates a standard for allowing margin sharing that the Company, in fact, satisfies. First, the Attorney General either is confused as to Department precedent or is exaggerating the opportunity available to the Company under margin sharing. The Attorney General repeatedly asserts that the Company has somehow sought to retain twenty-five percent of total margins. AG In. Br., pp. 7, 14, n.13. In fact, the Company understands that the Company would only be entitled to retain twenty-five percent of the amount by which performance in a given year for a particular category of optimization transaction exceeds the prior year's performance. Co. In. Br., pp. 22-23; Interruptible Transportation, D.P.U. 93-141-A, p. 64. The Attorney General next miscasts the Company's proposal, asserting that the Company has proposed that a new "category" of transaction be established for margin sharing, namely "optimization". AG In. Br., p. 13. In fact, the record evidence is wholly contrary to this view. The Company explained that it proposed to assign each and every optimization transaction to the appropriate category (CR or OSS) and then measure performance against that category in the prior

[16] The margin sharing principles established in D.P.U. 93-141-A have been applied to CR transactions pursued through other "vehicles" such as asset management agreements. See Boston Gas, D.T.E. 99-76 (1999).

year. Tr. 35. Simply put, there is no need to create a "new" category as the existing categories fully apply to the transactions the Company proposes to pursue under the Agreements.

The Attorney General next seeks to draw a distinction between asset management agreements and the shorter-term CR and OSS transactions pursued within the alliance. The margins to be generated by the Company will result from the proceeds of CR and OSS transactions. Importantly, the Department did not limit margin sharing to long-term asset management agreements to address "slack" capacity. Instead the Department encouraged a wide range of "capacity management tools." In fact, the Department recognized that CR may be pursued on a "permanent or temporary basis," by posting a price or "through a pre-arranged agreement". <u>Interruptible Transportation</u>, D.P.U. 93-141-A, pp. 47-48. Thus, the distinction cited by the Attorney General (longer term CR agreements, which he views as appropriate for margin sharing, versus a series of shorter term CR arrangements through the alliance, which he views as inappropriate) was, in fact, rejected by the Department.[17]

The Attorney General then challenges the Company's legitimate margin sharing proposal by a highly strained comparison to <u>Risk Management</u>, D.T.E. 01-100-A. AG In. Br., pp. 10-11. The Attorney General suggests that "alliance-type" savings are somehow analogous to the price volatility management techniques considered in D.T.E. 01-100-A.

In fact, such comparison does not hold up. In D.T.E. 01-100-A the Department considered the rate treatment of alternate resource portfolio strategies that include, as a portfolio objective, the goal to mitigate price volatility (as compared to securing the "least" cost gas supply). The use of CR and OSS (whether through asset management agreements or more innovative structures such as the alliance) is designed to reflect the

[17] The Attorney General apparently favors longer term deals regardless of whether such transaction maximizes benefits for customers. As shown in the competitive solicitation pursued by the Company, the Agreements reflected the most attractive proposal for the benefit of customers. Exh. AG-1-19, Att. I.

fact that "excess resources [that facilitate CR and OSS] exist . . . only because firm customers have been allocated the full cost of developing these resources . . . ." Interruptible Transportation, D.P.U. 93-141-A, p. 59. Berkshire is merely seeking to return the greatest value that can be secured from these resources. Optimization does not reduce volatility. If anything, optimization may be more available in a volatile market. Berkshire understands its goal should be to generate and return margins to customers. The Company's margin sharing proposal remains consistent with this objective and avoids the "disincentive" that results when all margins are returned to customers.[18] The Department should continue to recognize the value and benefits of the alliance structure.

The Attorney General next argues that the Department should be wary of approving the Company's margin sharing proposal as other companies, such as KeySpan, may also seek to be treated comparably. AG In. Br., pp. 13-14. This rather confusing and startling argument would apparently have the Department disregard its obligation to apply reasoned consistency in its decisions. See Boston Gas Company v. Department of Public Utilities, 367 Mass. 92, 104-105. (1975).[19]

The Attorney General goes on to suggest that margin sharing be allowed after independent and perhaps multiple audits. AG In. Br., pp. 13-14. The Department has, in fact, recognized that internal auditors may well be effective. Berkshire Gas, D.T.E. 02-19, pp. 17-18. Further, the Company is concerned that excessive "auditing" will only benefit accounting firms and will, in fact, work to the detriment of customers by adding costs or frustrating the ability of the Company to act responsively for the benefit of customers.

[18] Berkshire has enthusiastically supported the Department's efforts to foster a more competitive market for natural gas. The company is surprised that the Attorney General is essentially arguing against a proposal to reduce allocated costs to customers with the fewest practicable options. See AG In Br., pp. 10-11.
[19] The Attorney General here is also apparently concerned again that the alliance structure is "complex." AG In. Br., p. 11. The Department's prior decisions reflect an understanding of the Agreements and the greater opportunities now available to Berkshire.

The Attorney General concludes his arguments with respect to eligibility for margin sharing by offering a four-part test. AG In. Br., p. 14. The "test" provides that margin sharing for asset management or optimization should be allowed only when:

> (1) the Company clearly demonstrates that there are proven benefits; (2) the Company conducts an independent assessment that shows the activities being encouraged have been reported accurately; (3) the activities are done for the benefit of the Company's ratepayers; and (4) any program that incorporates incentives also ensures that ratepayers receive safe, reliable and least cost service.

Id.

If this is the appropriate test, then the Department should find that the Company's margin sharing proposal relating to alliance-related CR and OSS surely passes. Not only does the Company's testimony show that each of these components has been satisfied but, more significantly, so do the prior findings of the Department with respect to the alliance. Co. In. Br., pp. 22-23. The Department has found that the alliance is "consistent with the Company's portfolio objectives," ensures, by its key terms, that customers will pay no more for natural gas than under the approved resource mix, that customers will likely benefit from the alliance even under the most unfavorable conditions, that the alliance contributes to a least resource plan and that the alliance is in the public interest. Berkshire Gas, D.T.E. 02-19, pp. 16-17. Thus, the Agreements satisfy the first component of the Attorney General's test. As to the need for the performance of an independent assessment of allocation activities, the Company has its own representative on the allocation team, is able to review transactions independently at execution and has benefited from periodic audits that it has elected to pursue. Thus, the Company confirms proper savings calculations and allocations independently.[20] As

[20] If the Attorney General intended to argue that appropriate audits may only be performed by outside auditors, he disregards the fact that the Department rejected this argument in D.T.E. 02-19. An internal auditor is subject to comparable standards, will likely have greater industry expertise and will ultimately have its work reviewed by external auditors, thereby securing a second layer of audit review.

noted above, the Department has found that the alliance "would benefit the Company's customers" (D.T.E. 02-19, p. 17), thus satisfying the third component of the Attorney General's test. The alliance ensures safe, reliable and least cost service thereby satisfying the fourth component of the Attorney General's standard. As noted, no long-term assignment of capacity is made. Thus, the approved, least cost reliable resource portfolio remains available for the benefit of the Company's customers. In fact, as compared to the Attorney General's favored asset manager structure, the alliance maintains greater reliability as the Company is not exposed to the risk that the asset manager might become bankrupt. See also Exh. DTE-1-27 (The Netting Agreement was structured to protect the Company's customers from bankruptcy risk). Further, Berkshire's reliability is necessarily enhanced when it works with the largest producer and reserves holder in North America. Co. In. Br., p. 15; Exh. AG-1-19, Att. I. In sum, the Company has satisfied even the Attorney General's own purportedly higher standard for margin sharing eligibility.

Accordingly, for all the reasons stated in Ms. Zink's testimony, the Company's Initial Brief and this Reply Brief, as well as the fact that Berkshire has satisfied the Attorney General's own higher standard, the Department should approve the Company's margin sharing proposal for CR and OSS pursued through the alliance. Alternatively, the Department should accept the Company's alternative proposal that all alliance transactions be considered in the aggregate for purposes of margin sharing.

VI. THE COMPANY HAS PROPERLY REFLECTED ALLIANCE COSTS WITHIN ITS CGAC

The Company has clearly presented to the Department how a portion of the costs of securing the 2002 Optimization Agreement were treated in the Seasonal Cost of Gas Adjustment Clause ("CGAC"). The Company's CGAC filings as well as required annual reports relating to the alliance have clearly presented this treatment. In fact, the Company's CGAC filings have only addressed a portion of the costs associated with the

2002 Agreements, namely the costs associated with securing required Department approval. Exh. AG-1-78; Tr. 174. No costs associated with drafting the relevant RFP, reviewing bids, negotiating with bidders, finalizing contracts and related agreements and other substantial legal services were reflected in the CGAC. Moreover, no charges from the Company's affiliates for services such as coordination of nominations, trading, allocation of savings, or conducting audits are recovered in base rates.

The alliance is a sophisticated and aggressive approach to secure maximum value for the benefit of customers through the exploitation of market advantages associated with a larger and more diverse resource portfolio facilitated by mergers with Energy East. In fact, the Company has been extremely aggressive in terms of its optimization activities. In nearly every single recent year, the Company has incurred substantial costs in this area by either issuing RFP's, negotiating contracts, presenting cases to the Department and administering resource portfolio optimization agreements. However, the Company's base rates reflect essentially no costs in this area even though substantial costs have been and will continue to be incurred in each year in the course of securing benefits for customers. As noted, in D.T.E. 99-81, the Department approved an asset management agreement with Energy USA-TPC Corporation ("EU-TPC") where the solicitation, negotiation and relevant regulatory proceeding were all completed in calendar year 1999. The Berkshire Gas Company, D.T.E. 99-81, p. 1 (1999). Subsequently, Berkshire announced its agreement to merge with Energy East in late 1999 and the merger was completed in late 2000. The Berkshire Gas Company, D.T.E. 01-56 (2002). On October 16, 2002, the Company submitted for information a second, short-term agreement with EU-TPC for the period November 1, 2000 through March 31, 2001. The Company explained that this "interim" procedure would enable Berkshire "to participate in a formal solicitation for the terms and conditions of [a] new arrangement for the management of the [the Company's supply, storage and transportation] assets in a coordinated process with other EEC entitles." Thus, the contract with EU-TPC was updated only for new dates that reflected the interim term and a short informational filing letter was presented to the Department, both involving only de minimis costs during 2000, the Company's rate case test year. Berkshire Gas, D.T.E. 01-56, p. 1.

Thereafter, in 2001 the Company issued an RFP, negotiated at substantial expense a sophisticated set of alliance agreements and pursued DTE approval of the 2001 Optimization Agreements. Berkshire Gas, D.T.E. 01-41 (2001). The Company also worked daily within the alliance structure to secure savings and then track and allocate such savings. In 2002, the Company reviewed bids received from an RFP issued in late 2001, completed an internal audit of alliance procedures and controls, implemented the 2001 Optimization Agreements for the first quarter and negotiated and secured regulatory approval for the 2002 Optimization Agreements. Berkshire Gas, D.T.E. 02-19 (2002). Calendar years 2003 and 2004 have included substantial additional costs including the costs associated with the administration of the 2002 Agreements, the Joint RFP, negotiation of the Agreements and the pending proceeding.

As can be seen, the Company regularly incurs substantial optimization-related costs, yet the Company's base rates essentially do not provide for the recovery of any of the substantial costs associated with the optimization of the Company's resource portfolio. Tr. 173-175. As noted, the Company incurred only de minimis costs during the rate case test year. Moreover, the Department did not permit the Company to recover any affiliate charges in base rates. Berkshire Gas, D.T.E. 01-56-A, pp. 32-33 (2002); Tr. 173-175. Thus, absent the Company's offset of at least a portion of the transaction-related expense associated with the Department case, the Company would, in essence, be punished for pursuing an opportunity that the Department found to be "consistent with the public interest" due to the benefits associated with the 2002 Optimization Agreements. Berkshire Gas, D.T.E. 02-19, pp. 16-17.

The Company's CGAC tariff (M.D.T.E. 329), provides that "all costs of firm gas including, but not limited to . . . other gas supply expenses incurred to procure and transport supplies . . . " are reasonable for recovery through such charge. See Section 3.0. There are only two limitations. First, the costs must be identified and explained in required semi-annual filings, which has been done by the Company. The other limit is that costs "reflected in the base rates are not recoverable through this CGAC." As noted, no costs (legal or affiliate) associated with the alliance are "reflected" in base rates. These costs are real and substantial. Neither limitation in the CGAC tariff applies, the charges were reasonable and properly relate to gas supply procurement and, therefore, the Company's CGAC treatment was appropriate.[21] Accordingly, the Department should affirm the Company's CGAC treatment of costs associated with the 2002 Agreements.

VII. CONCLUSION

In summary, the Company has demonstrated that the Portfolio Agreement and the Purchase Agreement will enhance Berkshire's portfolio objectives of providing its customers with lower gas costs while enabling Berkshire to continue to provide safe, reliable service. Accordingly, for all the reasons stated herein and in the Company's Initial Brief, the Company respectfully requests that the Department take such actions as may be necessary and appropriate and issue an order approving the Agreements pursuant to G.L. c. 164, §§76 and 94A, to affirm that the Department's established margin sharing principles apply to margins secured within the alliance structure and to

[21] If anything, the Company's proposal is conservative and beneficial to customers as it only addresses a portion of eligible CGAC costs.

affirm the Company's treatment of certain legal costs associated with the 2002 Agreements was appropriately reflected in the Company's CGAC.

Respectfully submitted,

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